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Harmonizing Capital Adequacy Rules for International Banks and Securities Firms

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Cover Page Footnote

International Law; Commercial Law; Law

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Nancy Worth †

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I. Introduction

The emergence of financial conglomerates which engage in a broad array of activities has challenged nations' abilities to ensure the competitiveness and the safety of their financial systems. Regulators have become increasingly concerned that a banking or securities crisis in one country could threaten the safety of the global financial system.

The responses of regulators generally are governed by the structure of their respective financial systems. Some nations prohibit a single entity from engaging in both banking and securities activities, while others permit a single entity to provide all forms of financial services. Other countries have a mixed system, allowing a broad array of financial services to be conducted through different entities.

The International Organization of Securities Commissions (IOSCO)¹ has attempted to establish a common framework for the international regulation of securities firms and towards this end, has expressed a willingness to cooperate with the Basle Committee on Banking Regulation and Supervisory Practices (the Basle Committee).² At IOSCO's annual meeting held in Washington in September of 1991, securities regulators tentatively endorsed certain basic prin-

¹ See IOSCO, 1989 ANNUAL REPORT (1990); IOSCO, 1990 ANNUAL REPORT (1991), *Memorandum From IOSCO's Technical Basle Committee on Banking Supervision, app. A*, IOSCO (Sept. 1991)(XVI Annual Conference of IOSCO) [hereinafter, *IOSCO Memorandum*].

In September, 1991, IOSCO held its 16th Annual Conference. By October 1991, IOSCO had ninety-one members, including sixty security firm regulators; the remaining members include exchanges and other self-regulatory organizations.

The Technical Committee, which was established in 1987, currently has four subcommittees:

- Working Party 1: Multinational Disclosure and Accounting,
- Working Party 2: Regulation of Secondary Markets,
- Working Party 3: Regulation of Market Intermediaries, and
- Working Party 4: Enforcement and the Exchange of Information.

See *id.* at 7.

The focus of this Article is on Working Party 3.

² The Basle Committee, which meets at the Bank for International Settlements in Switzerland, is comprised of the representatives of the central banks and supervisory authorities of the Group of 10 members (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and the United States) and Luxembourg. In 1988, it produced a final version of proposed capital adequacy standards for internationally active banks. Basle Committee members have promised to fully implement these standards by January 1, 1993. BANK FOR INTERNATIONAL SETTLEMENTS COMMITTEE ON BANKING REGULATION AND SUPERVISORY PRACTICES, *Report on International Convergence of Capital Measurements and Capital Standards (Revised Basle Agreement)*, AMERICAN SOCIETY OF INTERNATIONAL LAW (July 1988) [hereinafter *Basle Accord*].

A 1990 survey indicated that eight members had begun to implement them: Canada, France, Germany, Japan, Sweden, Switzerland, United Kingdom, and the United States; other EC members will meet them when they implement EC directives. See INTERNATIONAL

ciples on capital adequacy in a Memorandum from IOSCO's Technical Committee to the Basle Committee on Banking Supervision. IOSCO stated that it was "willing, in principle, to conclude as a first step, an agreement with the Basle Committee of Banking Supervisors which would establish an international standard for market risk requirements and a definition of permitted regulatory capital."³

In January of 1992, the Basle Committee and the Technical Committee of IOSCO met jointly for the first time. At that meeting, both committees reached preliminary understandings related to the development of (1) international capital requirements for banks that take into account interest rate risk on tradeable securities and price risk on equity positions held by banks; and (2) minimum capital levels for international security firms and methods to reduce market distortions arising from the different regulatory treatment of interest rate risks and credit risks.⁴ Regulators also reached a consensus that a building block approach, an approach that separates specific issuer risks and general market risks, should be applied to assess capital requirements against debt securities held by banks or security firms and for all equities held by banks. Some securities regulators would apply the same approach to equities. A majority of bank supervisors, however, seemed willing to follow the approach of securities regulators for assessing capital requirements against the securities trading conducted by banks.⁵

At the end of June 1992, the Finance Ministers of the European Community agreed in principle on the proposed directive on capital adequacy which requires banks to treat trading activities in the same fashion as securities firms and directs securities firms to treat non-trading activities in a manner similar to banks for purposes of capital requirements. The new draft of the Directive still must be approved by the European Parliament.⁶

This article posits that regulators should ensure that financial conglomerates are regulated in a manner that helps maintain the safety and soundness of the global financial system. Specifically, this

MONETARY FUND, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS AND PROSPECTS 36 (1991) [hereinafter IMF, CAPITAL MARKETS].

³ IOSCO Memorandum, *supra* note 1, at 2.

⁴ Richard C. Breeden and E. Gerald Corrigan, Joint Statement at the Meeting Between IOSCO and the Basle Committee on Banking Supervision (Jan. 1992) [hereinafter Joint Statement]. Progress may be slow, however. Following a July meeting of the Technical Committee of IOSCO, Richard Breeden indicated that he would send a letter to Gerald Corrigan outlining points of contention within IOSCO and between IOSCO and the Basle Committee. See *Disagreement Plagues Committee Discussions on Harmonized International Capital Standard*, INT'L SEC. REG. REP., July 28, 1992, at 1.

⁵ Joint Statement, *supra* note 4, at 2.

⁶ See *Credit Institutions: Capital Adequacy Negotiations Wrapped Up and Breakthrough on Investment Services*, EUROPEAN INSIGHT (July 3, 1992) [hereinafter *Credit Institutions*]; Amended Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, 1992 O.J. (C 50) 5 [hereinafter Amended CAD].

article argues that functional regulations should be designed to separate banking and securities activities and to mandate the assessment of capital requirements by activity regardless of whether this entity is a bank or security firm. Part II of this article explores the risks faced by securities firms and bankers and the regulatory responses proposed in various international fora. Part III focuses on the efforts of IOSCO to develop a consensus on similar types of rules for securities regulators. Part IV compares the emerging consensus among securities regulators with that of banking regulators. Part V examines the European Community's (EC) latest proposal for a Capital Adequacy Directive (CAD). Part VI concludes that efforts to coordinate regulation among securities firms and between securities firms and banks will continue and may eventually lead to a common approach for regulating financial conglomerates.⁷

II. Basic Questions

A. *What Are the Differences Between Banks and Securities Firms?*

1. *Theory: Banks and Securities Firms Are Two Different Entities*

In principle, banks and securities firms serve two distinctly different functions. Banks are viewed as quasi-public institutions that act as: (1) depositories which serve as custodians of the public's savings; (2) intermediaries which channel funds from savers, in the form of deposits, toward consumer and business borrowers, in the form of loans; and (3) payment intermediaries which provide liquidity to consumers and businesses.⁸ In contrast, securities firms are risk-taking institutions which serve an intermediary function, in part, by bringing together investors and borrowers who issue securities. Reflective of these roles, the goal of bank regulators traditionally is to ensure the safety and soundness of the banking system,⁹ whereas the goal of securities regulators is to protect investors.¹⁰

Traditionally, bank assets (loans) are mostly long-term and unmarketable.¹¹ The major risk faced by banks is credit risk, that is, the

⁷ This article was prepared before the October 1992 annual meeting of IOSCO. It is possible that some changes may occur at that conference.

⁸ Vincent Di Lorenzo, *Public Confidence and the Banking System: the Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 AM. U.L. REV. 647, 648 (1986) [hereinafter *Public Confidence*]; see also 1 MICHIE, BANKS, AND BANKING § 2 (A.D. KOWALSKY et al. eds.) (1986 & Supp. 1992).

⁹ Di Lorenzo, *Public Confidence*, supra note 8, at 648.

¹⁰ See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries*, 41 FIN. MKT. TRENDS 17, 20 (1988) [hereinafter *OECD, Regulatory Arrangements*]; U.S. GENERAL ACCOUNTING OFFICE, *REGULATION OF INTERNATIONAL SECURITIES MARKETS* 11 (1989), microformed on GAO/NSIAD-89-115 [hereinafter *GAO, INTERNATIONAL SECURITIES MARKETS* 89-115].

¹¹ See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *SYSTEMIC RISKS IN SECURITIES MARKETS* 45 (1991) [hereinafter *OECD, SYSTEMIC RISKS*].

risk that a borrower cannot repay debts.¹² Banks also face market risk, in the form of liquidity risk, the risk that they can not meet a financial obligation to a customer, creditor, or investor, and price risk, the risk to earnings arising from changes in interest and foreign exchange rates and from market volatility.¹³

Banks maintain a capital base to protect against these risks. The major component of their capital requirements is determined by first assigning weights to different types of assets and then assessing capital as a percentage of risk-weighted asset requirements.¹⁴ Further, banks generally have two safety nets if they experience difficulty: (1) short-term emergency assistance from the central bank; and (2) a deposit insurance scheme that protects depositors. The *quid pro quo* for official central bank support is tight, prudential supervision and capital adequacy requirements.¹⁵

Bank supervisors assume that banks hold most assets to maturity and, therefore, credit risk is the predominant risk.¹⁶ Thus, bank assets (loans) are not valued at market prices (marked-to-market).¹⁷ Supervisors seek to prevent "fire sales" of assets that would lead to bank difficulties requiring central bank assistance or the use of deposit insurance. The present regulatory tools include: (1) a requirement of portfolio diversification; (2) credit limits related to capital; (3) capital requirements; (4) reserve requirements; (5) deposit insurance; (6) record-keeping and reporting rules; and (7) examinations by supervisors.¹⁸ Despite the focus on credit risk, supervisors also take into account, at least to some extent, market risk.¹⁹ When bank regulators associated with the Basle Committee harmonized regula-

¹² See *Basle Accord*, *supra* note 2.

¹³ See CITICORP, 1990 ANNUAL REPORT 38 (1991). Banks manage their market risks through the creation of committees that examine liquidity, interest rate sensitivity, and other critical variables. Securities firms also manage market risks closely. Salomon Brothers has a daily Departmental management reviews to examine marked-to-market valuations. SALOMON, INC., 1990 ANNUAL REPORT 29 (1991).

¹⁴ See *Basle Accord*, *supra* note 2.

¹⁵ See IMF, CAPITAL MARKETS, *supra* note 2, at 44.

¹⁶ See INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, CAPITAL ADEQUACY STANDARDS FOR SECURITIES FIRMS 25-26 (1989) [hereinafter, IOSCO, INITIAL REPORT].

¹⁷ *Id.* at 26. Nonetheless, banks, at least in some countries, may report unrealized gains and losses. See, e.g., CITICORP, 1990 ANNUAL REPORT at 56; CHEMICAL BANKING CORP., 1990 ANNUAL REPORT, 48, 50 (1991).

¹⁸ See IMF, CAPITAL MARKETS, *supra* note 2, at 44.

¹⁹ See *Basle Accord*, *supra* note 2, ¶¶ 42, 43. The Basle Accord requires at least some capital to back off-balance sheet items (which include guarantees, interest rate swaps, and foreign exchange commitments). A bank translates its off-balance risks into "credit risk equivalents" that then counts as part of risk-weighted assets. An alternative approach can be used for interest rate and foreign exchange commitments, under which a bank marks these commitments or obligations to market, that is, values them at market prices, and adds an extra amount of capital to cover bank exposure over the period of exposure. The effect is to capture at least part of the general market risk related to changes in interest rates. *Id.* ¶¶ 42, 43, annexes 2-3.

tions regarding bank capital, the focus was on credit risk.²⁰ The Basle Committee plans to address risks stemming from interest rates, foreign exchange movements, and other market risks.²¹

Securities firms trade for their own account, underwrite new issues, serve as secondary market makers and act as agents when they implement customer orders.²² They also act as intermediaries between borrowers and investors. Further, they serve as brokers by acquiring securities for their customers' accounts and as dealers by holding or trading securities for their own accounts. Securities firms' assets are highly marketable in the very short term, but are exposed to the risk that market prices fluctuate.²³ Securities firms accept the market risk that prices for securities will vary dramatically because of the specific risk relating to the issuer of the securities by taking a position that is large in relation to the total market for that security (concentration).²⁴ They also accept general market risks related to changes in interest rates, exchange rates, and other variables.²⁵

Securities firms' primary credit risk is increased costs if their counter-parties (clients or traders) delay or default because of changes in prices in the underlying securities, delays in domestic or international settlement or other reasons.²⁶ Unlike banks, securities firms generally do not have direct access to official safety nets. They do, however, benefit when central banks aim to inject liquidity in times of market crisis.²⁷ In contrast to bank regulators, who aim to minimize risks, securities regulators aim to create a fair and transparent framework for risk taking.²⁸ Securities regulators also take a more comprehensive approach to regulation and focus on both credit/counter-party risk, also referred to as settlement risk, and market risk, also referred to as position risk. Reflecting the highly marketable nature of securities and the trading activity of securities firms, regulators require that securities be valued at daily market

²⁰ *Id.* ¶ 8.

²¹ *Id.*; but cf. Richard C. Breeden, Remarks of Richard C. Breeden, Chairman of U.S. Securities and Exchange Commission to the Institute of International Bankers 10 (May 27, 1992) ("Though Basle standards seem to have worked reasonably for credit risk, the decision to postpone developing the methodology for quantifying interest rate risk and imposing capital requirements against it seems unfortunate.")

²² See IOSCO, INITIAL REPORT, *supra* note 16, at 8.

²³ *Id.* at 11.

²⁴ *Id.* at 12.

²⁵ See *id.*

²⁶ See *id.* at 12-13.

²⁷ Thus, unlike a system of bank deposit insurance, individual securities firms or intermediaries can fail and their customers will lose money. In countries with a universal banking system or with a hybrid system that allows banks to have securities subsidiaries, securities firms, intermediaries and customers will benefit directly from central bank injection of liquidity. See OECD, SYSTEMIC RISKS, *supra* note 11, at 44.

²⁸ See OECD, *Regulatory Arrangements*, *supra* note 10, at 24.

prices, "marked-to-market", to take into account both market risk and credit risk.

Net capital of securities firms is roughly defined as the firm's net worth minus non-liquid assets plus subordinated debt.²⁹ If customer accounts are segregated, this definition is basically a capital requirement on the positions taken by the firm on its own behalf. Merely valuing the security at its market price is not enough, however, because this valuation reflects past price changes rather than the price at which the firm may be required to liquidate its holdings in the future and does not take into account counter-party risks.³⁰ Therefore, securities firms count something less than the full market value of securities held as part of net capital. That deduction is referred to as a "haircut". The haircut may be 100% where none of the security would count as part of net capital, if the security is non-liquid and hence, particularly risky.³¹ The haircut on securities that are marked-to-market effectively achieves in one calculation what, for banks, is a two-step process of determining risks and setting capital requirements against risk-weighted assets.

Securities firms also have initial entry or base capital requirements and minimum capital requirements designed to protect customers in the event of a counter-party default. Customers do not need protection from a firm that does not deal with them.³² Thus, a firm acting on its own behalf will need less capital than one that acts on behalf of third parties without receiving securities or client funds.³³ In turn, firms that receive client securities or funds, but segregate them and promise delivery on request, will need less capital than one that does not segregate client funds.³⁴ Among the main methods of securities regulators are: (1) the establishment and enforcement of standards for disclosure about the nature of the securities; and (2) the monitoring of securities professionals to prevent

²⁹ Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1992). See *Definition of Capital*, compiled in *Capital Requirements for Multinational Securities Firms*, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (Nov. 13, 1990) (XV Annual Conference of IOSCO in Santiago, Chile, Tome 1) [hereinafter IOSCO, *Remarks*].

³⁰ See *Comparison of Equity Position Risk Requirements and Scope for Harmonization*, compiled in *Capital Requirements for Multinational Securities Firms*, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (Nov. 13, 1990) (XV Annual Conference of IOSCO in Santiago, Chile, Tome 1) [hereinafter IOSCO, *Equity Position Risk*]. The specific risks for a security is captured in the daily mark to market requirement because, for example, a gradual deterioration in credit standing should be reflected in the market price of exchange traded securities. *Id.*

³¹ *Id.* ¶¶ 13-14.

³² See *The Base Requirement and Minimum Requirement for Capital*, compiled in *Capital Requirements for Multinational Securities Firms*, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (Nov. 13, 1990) (XV Annual Conference of IOSCO in Santiago, Chile, Tome 1) [hereinafter IOSCO, *Base Capital Requirements*].

³³ *Id.*

³⁴ *Id.*

manipulation and fraud.³⁵

2. *Practice: Banks and Securities Firms can be Part of One Entity*

In practice, the line between securities firms and banks is considerably less distinct than the preceding analysis would suggest. The terms "securities firms" and "banks" encompass a wide variety of entities. At one extreme, the United States³⁶ and Japan³⁷ severely restrict banks' ability to engage in securities businesses, although these restrictions are weakening as bank regulators redefine what banks can do. In contrast, in countries such as Austria, Germany, and Switzerland, banking and securities activities are combined into a single entity, called a "universal bank."³⁸ In Germany and Austria, anyone seeking to engage in securities trading must obtain a banking license.³⁹ Some countries have a mixed or hybrid system that permits banks to engage in banking and allows both banks and non-banks to carry out securities activities.⁴⁰

Some countries allow securities activities to be conducted in a subsidiary of a bank or a holding company.⁴¹ A financial conglomer-

³⁵ OECD, *Regulatory Arrangements*, *supra* note 10, at 20.

³⁶ Universal banking, defined as banks that are permitted to engage in both banking and security transactions, is prohibited in the United States and in Japan, but the edges of this prohibition have become increasingly frayed. For example, U.S. banks can: (1) have affiliates dealing in municipal obligations, mortgage-backs, and commercial paper; and (2) own a discount brokerage if it does not take positions in securities. The Federal Reserve has loosened its definition, under section 20 of Glass-Steagall, of "not principally engag[ing]" in securities activities. Thus, bank-holding companies will not now violate section 20 of Glass-Steagall if revenues from security transactions are less than ten percent (first introduced in 1987 with 5% ceiling). See IMF, *CAPITAL MARKETS*, *supra* note 2, at 41; see also Glass-Steagall Act § 20, 12 U.S.C. § 377 (1989).

³⁷ Japanese banks can enter securities business abroad, but not at home. A 1989 paper on universal banking in Japan examined five approaches: subsidiary approach, either separate or multi-functional, holding company, universal bank and piecemeal, for developing a universal banking system. Japan's Financial System Research Council, affiliated with the Banking Bureau of the Ministry of Finance, issued second report in 1990, focusing on two approaches to integration: subsidiary or a multi-functional unit that could, at the wholesale level, engage in a variety of financial activities. At the same time, Fundamental Research Council, affiliated with the Securities Bureau of the Ministry of Finance, urged separate subsidiaries and firewalls. See IMF, *CAPITAL MARKETS*, *supra* note 2, at 41.

³⁸ OECD, *SYSTEMIC RISKS*, *supra* note 11, ¶ 37. Belgium, Denmark, Finland, Luxembourg, Norway, Portugal, and Sweden also have universal banking systems. OECD, *Regulatory Arrangements*, *supra* note 10, at 24. But, these countries also permit nonbank entities to engage in securities transactions and could also be called hybrid systems. OECD, *SYSTEMIC RISKS*, *supra* note 11, ¶ 132.

³⁹ CONGRESS OF THE UNITED STATES, OFFICE OF TECHNOLOGY ASSESSMENT, *TRADING AROUND THE CLOCK: GLOBAL SECURITIES MARKETS AND INFORMATION TECHNOLOGY* 72, n.11 (1990) [hereinafter, OTA, *TRADING AROUND THE CLOCK*].

⁴⁰ These include: Belgium, Canada, Finland, France, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. OECD, *SYSTEMIC RISKS*, *supra* note 11, ¶ 37.

⁴¹ Banks can own securities subsidiaries in the United Kingdom. U.S. bank holding companies can, subject to strict limitations, engage in securities activities. See IMF, *CAPITAL MARKETS*, *supra* note 2, at 41.

ate may also be in the insurance business.⁴² The type of position that a securities firm may take differs among countries. France, for example, is moving away from a system where the securities firm acts solely as a broker and does not take a position in equities. Securities firms in Japan and the United States act as dealers when they take positions and as brokers when they match orders. Securities firms also may act solely as dealers by taking a position on their own books in every trade that they execute.⁴³

Securities regulators may be grouped into four main patterns.⁴⁴ Universal banks are regulated mainly by one banking supervisor.⁴⁵ In a hybrid system, a banking supervisor may regulate the banking and securities activities of a bank, while a securities regulator supervises brokers. Alternatively, a single entity in a mixed system may be subject to regulation by two agencies that agree on how to regulate the entity.⁴⁶ In a strictly separated system, bank regulators will regulate banks, while securities regulators will regulate securities firms.⁴⁷

Other regulatory features also differ widely.⁴⁸ One distinction is what the regulators are empowered to regulate. In the United States, for example, there are different regulators for banks, securities markets, and futures markets, and there are significant differences in what activities are regulated. For example, U.S. subsidiaries of regulated securities firms are not, themselves, regulated. Thus, U.S. securities firms have an incentive to shift activities, such as interest rate swaps, bridge loans, and foreign exchange, to subsidiaries in order to reduce the costs of meeting capital and other regulatory requirements.⁴⁹ Therefore, without agreements on how to regulate securities activities internationally, a foreign securities subsidiary from a country that maintains separate banking and securities firm regulators may go unregulated in a country that has only banking regulators and assumes that the home country is doing the regulation. The

⁴² See MERRILL LYNCH & CO., 1990 ANNUAL REPORT 45 (1991); MERRILL LYNCH & CO., 1990 10K, 6 (Merrill Lynch has an insurance subsidiary, a U.S. edge act corporation that trades foreign exchange, and a London-based bank subsidiary that trades foreign exchange, lends, and accepts deposits).

⁴³ See IOSCO, *Equity Position Risk*, *supra* note 30, at 6.

⁴⁴ The following discussion is based on OECD, *Regulatory Arrangements*, *supra* note 10, at 25-26.

⁴⁵ Note, however, some aspects of securities regulation might be left to self regulatory organizations or local regulators. See *id.* (discussing the German system; the stock exchanges, for example, are not subject to supervision from bank regulators).

⁴⁶ In the United Kingdom, a "lead regulator" is designated. In Spain, there are formal arrangements to share regulatory responsibility. See *id.* at 26.

⁴⁷ In the United States, a bank may have a securities subsidiary; the bank will be regulated by bank supervisors and the securities subsidiary will be regulated by the securities and to some extent the banking, regulators. See UNITED STATES GENERAL ACCOUNTING OFFICE, ACTIVITIES OF SECURITIES SUBSIDIARIES OF BANK HOLDING COMPANIES, GAO/GGD 90-48 (1990)[hereinafter, GAO, SECURITIES SUBSIDIARIES].

⁴⁸ The discussion that follows is based on OECD, *SYSTEMIC RISKS*, *supra* note 11.

⁴⁹ OECD, *SYSTEMIC RISKS*, *supra* note 11, ¶ 142.

remedy for this patchwork coverage is for regulators to agree on who will cover what.

Another distinction in regulatory features utilized in different countries is whether the supervisory function for securities firms is primarily federal, as in the United States, or whether it is provincial, as in Australia, Canada, and Germany.⁵⁰ An additional difference is the extent to which the supervision is based on statutes, regulations promulgated by an administrative body, and regulations of a self-regulatory body.⁵¹ These distinctions add complexity to international efforts to harmonize regulations.

B. Why Harmonize Regulations?

1. The Key Reason: Systemic Risk

The main reason to harmonize financial regulation is to avoid a potential global financial meltdown by minimizing systemic risks. Systemic risks are those financial risks with the potential for effects reaching beyond the local economy in which they occur.⁵² Serious financial risks can stem from a crisis arising initially in firms, domestic financial markets, international financial markets or the global economy. For example, concerns about systemic risk arose in the Herstatt bank failure in 1974, in the emergence of the LDC debt crisis in 1982, and in the equity market plunges in 1987 and 1989. While a number of developments, including the advance in technology, the deregulation of foreign exchange and financial markets, the innovation in financial services and the rapid growth in international financial markets, have fostered the development of more efficient capital markets, regulators fear that these developments may also increase systemic risks.⁵³

A related concern is the potential for regulatory arbitrage. If the regulations of securities in one country is more relaxed than in a second country, it will be cheaper to attract business and to issue securities in the first country. The second country may then seek to reduce its securities regulation, which may be followed by reductions in regulation by the first country. This "race to the bottom" could

⁵⁰ A Federal Finance Ministry proposal urges the merger of German stock exchanges. See *EC Financial Market Regulations Analyzed at London Conference*, 58 BNA Banking Rep. No. 22, at 970 (June 1, 1992).

⁵¹ See International Organization of Securities Commissions, Working Party 1, *International Equity Offers*, in PAPERS PRESENTED AT THE XIV ANNUAL CONFERENCE IN VENICE ITALY (September 1989)[hereinafter, IOSCO, *International Equity Offers*].

⁵² See OECD, SYSTEMIC RISKS, *supra* note 11, ¶ 14 (citing Sean O'Connor, SYSTEMIC RISKS IN SECURITIES MARKETS); GAO, INTERNATIONAL SECURITIES MARKETS 89-115, *supra* note 10, at 26 (defining systemic risk as "the possibility that failure of a firm will spill over national boundaries, causing firms in other countries to fail.")

⁵³ See OECD, SYSTEMIC RISKS, *supra* note 11, ¶ 8. For example, concerns about systematic risks arose in the Herstatt bank failure in 1974, the emergence of the LDC debt crisis in 1982, and the equity market plunges in 1987 and 1989. *Id.* at 11.

reduce securities regulation to a point where investors do not receive effective protection. An alternative view of regulatory arbitrage is that investors seek to place their funds in the safest place, in which case there might be a "flight to quality" or a "struggle to the top."⁵⁴

A similar process of regulatory arbitrage could occur between banks and securities firms. In the 1980s, countries liberalized their financial systems⁵⁵ and made it possible for banks and securities firms to engage in new activities. If regulations permitted, one outcome of regulatory arbitrage might be that a bank would seek to restructure itself into a securities firm.

Competitiveness is another key concern as global markets become more integrated.⁵⁶ If securities regulation in one country makes issuing securities more expensive than in a second country, a company will choose to issue securities in the second country.⁵⁷ If bank regulation is more onerous than securities regulation, a company will choose to issue securities rather than to borrow from a bank.⁵⁸ At present, it may be that bank regulations make it more expensive to borrow from banks than to issue securities in some countries, while the opposite is true in other countries. To the extent that costs are equal for securities firms internationally or are equal for banks and securities firms, all institutions would be competing on a level playing field.

2. Possible Models for Harmonization

There are a number of different models of regulatory harmonization among securities firms and between securities firms and banks. Within a country, the highest degree of harmonization might be accomplished by designating one regulatory agency for both

⁵⁴ See GAO, INTERNATIONAL SECURITIES MARKETS 89-115, *supra* note 10, at 25; Caroline Bradley, 1992: *The Case of Financial Services*, 12 NW. J. INT'L. L. & BUS. 124, 156 (1991).

⁵⁵ See OECD, SYSTEMIC RISKS, *supra* note 11, ¶¶ 7-9 (citing the abolition of exchange controls, the reduction of barriers to entry to national markets, the unfixing of commission rates, and other factors); IMF, CAPITAL MARKETS, *supra* note 2, at 44.

⁵⁶ See IMF, CAPITAL MARKETS, *supra* note 2, at 33 (noting that international equity trading rose from \$73 billion in 1974 to \$1,528 billion in 1989, while the value of total world trading on secondary markets rose from \$7,025 billion in 1986 to \$11,717 billion in 1989).

⁵⁷ Or, at least, it may be cheaper to issue securities in many countries to raise the most amount of funds and to develop a broad, international market. An IOSCO paper notes that the popularity of multijurisdictional equity offers has increased, from \$6 billion in 1985 to \$48 billion in 1987 (although it fell to \$19 billion in 1988). Recent efforts have aimed at reducing the regulatory costs of disclosure so as to permit such offers. See IOSCO, *International Equity Offers*, *supra* note 51, at 15.

⁵⁸ In the United States, a number of large companies relied less on bank loans and more on issuing their own commercial paper in the 1980s. See Jan Shuijter, *Banks Under Stress: Analysis of Recent Developments in Banking*, OECD OBSERVER, Dec. 1991, at 19. It should be noted, however, that commercial paper issuers do not have the same disclosure burden as issuers of securities. See Securities Act of 1933, § 3(a)(3), 15 U.S.C. § 77c (1981) (noting exempt securities); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c (1981) (noting instruments that are not securities).

banks and securities firms which applies a common or at least a similar set of rules to each institution. Another looser approach is to have separate functional regulations and several regulators examine a financial institution, but to designate a "lead" regulator that coordinates the regulators' examinations of banking and securities activities.

Short of having the same regulator nationally or the same regulator internationally, harmonization can mean different things. Four models of financial harmonization are: (1) commonality; (2) comparability; (3) national treatment; and (4) mutual recognition.⁵⁹ Commonality involves setting universal minimum standards and is the approach adopted by the Basle Committee for banks and adopted by IOSCO for securities firms.⁶⁰ Comparability is based on the recognition and development of substantially equivalent, but not identical, rules.⁶¹ This approach was adopted by the United States and Canada in their approval of a single disclosure statement for multi-jurisdictional offers of securities of U.S. or Canadian entities, and in a Memoranda Of Understanding (MOU) which is designed to seek information and assistance to enforce domestic securities regulations.⁶² National treatment is the principle that a country subjects both domestic and foreign institutions to its own rules.⁶³ The United States generally follows this approach. Mutual recognition is the principle that allows a foreign firm to operate, within a country's borders, under the rules of the foreign firm's country of origin.⁶⁴ This is generally the approach taken by the European Community.⁶⁵

The mechanics of achieving harmonization among securities firms alone seem to present an almost insurmountable problem, at least initially. Securities firms operate under a variety of different regimes with substantial differences among them on what activities they may engage in (primarily securities activities or universal banking), who regulates them (ranging from one financial services regulator to different regulators for various activities and from a primarily national regulator to primarily state regulation), and whether they

⁵⁹ OTA, *TRADING AROUND THE CLOCK*, *supra* note 39, at 5.

⁶⁰ *Id.* at 5, 76.

⁶¹ *Id.*

⁶² *Id.* at 7.

⁶³ *Id.* at 5.

⁶⁴ *Id.*

⁶⁵ The GAO characterizes the European Community approach as a mixture of setting minimum standards, mutual recognition, and home country control. See GAO, *INTERNATIONAL SECURITIES MARKETS* 89-115, *supra* note 10, at 40. In the banking arena, European Community member countries that currently do not have universal banking are considered likely to adopt it so that their domestic banks are not disadvantaged, within their borders, relative to other EC banks. See GENERAL ACCOUNTING OFFICE, *EUROPEAN COMMUNITY: U.S. FINANCIAL SERVICES COMPETITIVENESS UNDER THE SINGLE MARKET PROGRAM*, GAO/NSIAD-90-99 (1990). For a description of the impact of competitiveness and regulatory arbitrage, see Bradley, *supra* note 54, at 124.

confront legal regimes with statute-based rules, administrative rules, or rules promulgated by a stock exchange.

An approach to harmonization that separates the regulation by the type of activity, whether banking or securities, might be achieved by having two separate regulators promulgate rules for a single entity or by having one regulator apply two sets of regulation to one entity. Overlapping systems of regulation and regulators could prove costly and politically awkward. This difficulty might be minimized by utilizing a system of coordination of regulators. Harmonization could proceed by developing one set of common minimum standards for securities firms and a separate set of common minimum standards for banks. Development of common international rules by a functional entity alone, however, does not solve the problem of regulatory arbitrage nor does it establish a level playing field because banks are also securities firms in some countries and both banks and securities firms can engage in similar activities. If common rules for different entities are developed, negotiations could then proceed to develop harmonized rules for both types of entities. This might be the most realistic way to proceed, given the experience of IOSCO and the Basle Committee.

3. *Current Efforts to Harmonize Regulations*

Several multilateral organizations presently focus on exchanging information in the securities arena.⁶⁶ These include IOSCO, the International Councils of Securities Dealers, and Self-Regulatory Associations, a group founded in 1988, consisting of SROs and Security Dealer Associations from Canada, Japan, the United Kingdom and the United States, and the Federation International des Bourses, a group consisting of thirty-three stock exchanges. The International Councils of Securities Dealers and Self-Regulatory Association expressly aim to promote harmonization of securities regulations.

IOSCO aims at coordinating securities regulation among countries. It has also exchanged proposals with the Basle Committee, a group of bank regulators, that move towards developing a partial convergence of bank and securities regulation. Several multilateral fora serve as a way to exchange information and as a source for potential proposals on the harmonization of financial regulations.⁶⁷ For example, although the Organization for Economic Cooperation and Development (OECD), an official agency with representatives from twenty-four industrial countries, is mainly concerned with encouraging global growth and the expansion of trade, it examines trends in financial flows and regulation. Similarly, the Group of 30,

⁶⁶ OTA, *TRADING AROUND THE CLOCK*, *supra* note 39, at 77.

⁶⁷ *Id.*

to which individuals from major international banks, multinational corporations, and government officials belong, examines issues in international economic and financial policy making. Additionally, the contracting parties to the General Agreement on Tariffs and Trade (GATT) are considering ways to facilitate trade in financial services.⁶⁸

The most extensive efforts at harmonization are underway in the EC. The EC's efforts to create a single market have spawned a number of proposals to harmonize monetary financial regulations. Several EC Directives specifically aim at harmonizing bank regulation in order to permit institutions licensed in one country to operate throughout the EC by the beginning of 1993.⁶⁹ Thus, a bank authorized to operate in one EC country will effectively have a "passport" to operate everywhere in the EC without obtaining authorization from each national authority. The EC is also considering two Directives, the Capital Adequacy Directive and the Investment Services Directive, that would harmonize investment firm capital standards and permit investment firms, like banks, to operate throughout the entire EC.

The CAD, as it was initially proposed in 1990, also seeks to:

- ensure the protection of individual investors and the safety and soundness of the financial system in the integrated European market,
- set a level playing field between banking and non-banking investment firms,
- boost the attractiveness of the EC as a financial center, and
- permit access to financial markets so as not to stifle competition.⁷⁰

Despite the professed objective of establishing a level playing field,

⁶⁸ GATT is a set of multipartite treaty rules. Originally, the rules were designed to be implemented as part of the International Trade Organization (ITO), which was supposed to be established as a special agency of the United Nations, like the International Monetary Fund and the International Bank for Development and Reconstruction. The ITO, however, was never established. Nonetheless, seven rounds of negotiations on trade rules have taken place and these have dramatically lowered tariff barriers to merchandise trade. In the current, Uruguay Round, some countries, led by the United States, have sought to add rules governing trade in services. See RALPH H. FOLSOM ET. AL. 1991 DOCUMENT SUPPLEMENT TO INTERNATIONAL BUSINESS TRANSACTIONS: A PROBLEM-ORIENTED COURSEBOOK 18 (2d ed., 1991).

⁶⁹ See IMF, CAPITAL MARKETS, *supra* note 2, at 36-37. In 1989, the EC adopted three key directives designed to create a single banking market. The Second Banking Directive, adopted by the EC Council in December 1989, harmonizes laws and rules for credit institutions and permits institutions licensed in one EC member country to operate throughout the entire EC. The Own Funds Directive, adopted by the Council in April 1989, establishes a standard EC definition of capital. The Solvency Directive, adopted in December 1989, sets forth EC rules on counter-party risk weights, treatment of collateral and guarantees, and other issues related to solvency. The thrust of these directives is broadly in line with the capital adequacy framework of the Basle Committee. A major difference between the EC and Basle Accord is that the EC directives mandate that tier-2 capital cannot include unrealized capital gains. *Id.*

⁷⁰ Opinion on the Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, Economic and Social Committee, 1991 O.J. (C 69) 1.

the draft of the CAD proposed in 1990 does not resolve the issue of harmonizing bank and securities firm regulation. Rather, the proposed Directive suggests that regulators examining universal banks should either apply the banking directives to the entire bank and the CAD to securities firms or separate the securities activities and apply securities standards to the securities portfolio and banking standards to the rest of the bank.⁷¹ The EC revised its proposal markedly at the end of January, 1992 by mandating that the CAD would apply to only the proprietary trading accounts of banks and investment firms.⁷² For securities firms, the rest of their activities would be subject to bank-like capital requirements, thus potentially requiring sharp increases in security firm capital requirements. In contrast, banks that could securitize assets, such as mortgages, could face a lower capital requirement.

III. IOSCO Consensus on Capital Requirements for Securities Firms

The *Memorandum from IOSCO's Technical Committee to the Basle Committee on Banking Supervision*, issued by IOSCO in September, 1991,⁷³ appears to reflect a consensus among securities regulators concerning a number of the key rules geared to establish a minimum level of capital adequacy. Nonetheless, securities regulators expressed reservations among themselves on how to ensure capital adequacy.

A. Capital Requirements of Securities Firms

1. United States

The Securities and Exchange Commission's (SEC) net capital rule specifies a minimum capital requirement, a base capital requirement and limits the amount of non-customer funds that count towards the net capital requirement. In addition, it specifies a maximum ratio of aggregate indebtedness to capital.⁷⁴ Under Securities Exchange Act Rule 15c3-1, net capital is generally defined as net worth less haircuts on securities positions minus non-liquid assets, like buildings, plus certain subordinated debt.⁷⁵ Subordinated loans are included in net capital because they are subordinated to the claims of all creditors. They must be approved for inclusion as regulatory capital by a self-regulatory organization, the initial term must

⁷¹ Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions 1990 O.J. (C 152) 6.

⁷² Amended CAD, *supra* note 6.

⁷³ See *IOSCO Memorandum*, *supra* note 1, at 1-3.

⁷⁴ The basic rule is that aggregate indebtedness cannot exceed 1500% of net capital. See 17 C.F.R. § 240.15c3-1(a) (1992). Aggregate indebtedness is defined as total money liabilities of a broker or dealer. *Id.* § 240.15c3-1(c)(1). A broker or dealer can escape from this limitation through compliance with the "alternative method." See *infra* text accompanying notes 84-86.

⁷⁵ 17 C.F.R. § 240.15c3-1 (1992).

be more than one year, and the loan cannot be repaid if repayment would reduce regulatory net capital below required amounts. In addition, loans from a person may not exceed, for more than ninety days, 70% of the securities firm's total of net worth and subordinated loans.⁷⁶

The rule describes brokers and dealers engaging in different types of activities and mandates an absolute minimum net capital requirement. Under the basic method for calculating net capital, brokers and dealers engaging in a general securities business shall maintain net capital of not less than \$25,000.⁷⁷ Other categories of brokers and dealers include clearing firms, introducing firms, new firms, firms in the business of writing options, market makers and specialists. Brokers and dealers cannot allow their aggregate indebtedness to exceed 1500% of their net capital.⁷⁸ This limit is effectively a base capital requirement equivalent to 6.67% of aggregate indebtedness.⁷⁹

The SEC takes a comprehensive approach towards counting a firm's proprietary trading activities as part of net capital. Securities are valued at market price (*i.e.* marked-to-market). The securities are further discounted through a system of capital charges, called "haircuts," that are based on market risk, price volatility and liquidity of individual securities. The haircuts are designed to protect against potential adverse movements in securities' prices related both to general market and to specific firm risks.⁸⁰

Haircuts for equity securities under the basic method set forth under the rule are 30% for readily marketable equities, 100% for those that are illiquid, which is defined as those that have no ready market and variable for debt instruments, depending upon time to maturity and upon the issuer and the amount that an option is covered or is out of the money.⁸¹ Additional haircuts may be applied for undue concentration.⁸² Some positions can be offset, because the

⁷⁶ *Id.* § 240.15c3-1(d).

⁷⁷ *See id.* § 240.15c3-1(a)(1). In September 1989, the SEC proposed a number of changes designed to strengthen the net capital rule. The main provisions would raise the absolute minimum requirement and reduce haircuts. Exchange Act Release No. 27,249, 54 Fed. Reg. 40,395 (1989). For example, broker dealers that carry customer accounts would have to maintain a minimum capital level of \$250,000. *Id.* For those that would be required to hold a minimum capital level of at least \$100,000, haircuts would be set at fifteen percent. *Id.*

⁷⁸ 17 C.F.R. § 240.15c3-1(a).

⁷⁹ UNITED STATES GENERAL ACCOUNTING OFFICE, SECURITIES MARKETS: CHALLENGES TO HARMONIZING INTERNATIONAL STANDARDS REMAIN, GAO/GGD-92-41 (1992) [hereinafter, GAO, SECURITIES MARKETS 92-41].

⁸⁰ *See* IOSCO, *Equity Position Risk*, *supra* note 30, ¶ 4. The specific risks for a security is captured in the daily mark to market requirement because, for example, a gradual deterioration in credit standing should be reflected in the market price of exchange traded securities. *Id.*

⁸¹ 17 C.F.R. § 240.15c3-1(c)(2)(vi) (various provisions).

⁸² *Id.* § 240.15c3-1(c)(2)(vi)(m).

securities firm's aggregate risk has been reduced. For example, a dealer with a short position of \$100 and a long position of \$100 in the same security will have a haircut that is less than a long position of \$200.⁸³

A broker-dealer can escape from the aggregate indebtedness limit and have lower haircuts by using the alternative method for calculating net capital. Under Rule 15c3-1(f), the general precept holds that a broker or dealer must maintain net capital equivalent to the greater of \$100,000 or 2% of aggregate debit items computed under the "Formula for Determination of Reserve Requirements" in Exhibit A to Rule 15c3-3.⁸⁴ Furthermore, haircuts are generally lower; haircuts on equity securities fall to fifteen percent. Like the basic method, the alternative method permits some positions to be offset.⁸⁵ Most large securities firms in the United States use this method.⁸⁶

2. International Comparisons

A number of securities regulators follow a comprehensive approach and rely upon a cushion provided by capital adequacy requirements. In France, Japan, the United Kingdom, and the United States, capital includes net worth, which is defined as share capital and retained earnings. In those countries, the net worth calculation is based upon securities positions that are marked-to-market and includes unrealized gains or losses.⁸⁷

Subordinated loans are counted as part of capital in France,⁸⁸

⁸³ A dealer takes a short position when he has sold securities that he does not own for future delivery, possibly because he expects to purchase the securities more cheaply in the future. A dealer takes a long position when he agrees to buy securities in the future. Under the Rules:

[T]he deduction shall be 30 percent of the market value of the greater of the long or short position and to the extent the market value of the lesser of the long or short position exceeds 25 percent of the market value of the greater of the long or short position, there shall be a percentage deduction on such excess equal to 15 percent of the market value of such excess

Id. § 240.15c3-1(c)(2)(vi)(j). An SEC proposal to reduce the 30% charge to 15% has been under consideration since 1989. Exchange Act Release No. 27,249, 54 Fed. Reg. 40,395 (1989).

⁸⁴ 17 C.F.R. § 240.15c3-1(f).

⁸⁵ The Rule provides:

[T]he deduction shall be 15 percent of the market value of the long positions. To the extent the market value of the short position exceeds 25 percent of the market value of long positions, there shall be a deduction equal to 30 percent of the market value of such excess. . . .

Id. § 240.15c3-1(f)(3)(ii). An SEC proposal to reduce the 30% charge to 15% has been under consideration since 1989. Exchange Act Release No. 27,249, 54 Fed. Reg. 40,395 (1989).

⁸⁶ See IOSCO, *Equity Position Risk*, *supra* note 30, ¶ 6. See also SOLOMON INC., 1991 FORM 10Q 8 (Oct. 31, 1991)(noting switch to alternative method after May 31, 1991); MERRILL LYNCH, 1990 ANNUAL REPORT 45 (1991).

⁸⁷ See IOSCO, *Equity Position Risk*, *supra* note 30, at 3.

⁸⁸ In France, the market authority must approve the use of subordinated loans as

the United Kingdom,⁸⁹ the United States, and in a number of other countries.⁹⁰ Like the United States, these countries limit the amount of subordinated debt that may be counted as part of capital. In Japan, only foreign firms are allowed to include subordinated loans as part of branch capital. Under certain circumstances, France⁹¹ and the United Kingdom⁹² permit the use of guarantees as part of regulatory capital. Japan and the United States do not count any guarantees. The ability to draw on subordinated debt helps securities firms adjust rapidly to changes in capital requirements on their rapidly changing portfolios that are marked-to-market.⁹³ It also gives parent holding companies flexibility in responding to the capital needs of the regulated securities firm subsidiaries.

Base or minimum capital requirements are generally designed to cover risks not directly linked to market or counter-party risks⁹⁴ and to provide a cushion to meet firm obligations in the face of business risks. They can be set by a variety of criteria, including floor amounts,⁹⁵ securities firms' expenditure volume,⁹⁶ the amount of as-

regulatory capital and, in aggregate, subordinated loans may not exceed three hundred percent of net worth. *Id.* at 6.

⁸⁹ Although all subordinated loans to U.K. security firms must have an initial term of at least two years, regulators distinguish between "long-term loans" that can be repaid on three month's written notice and "short-term loans" that can be repaid on two day's notice. Unlike the United States, U.K. regulators permit the uncommitted undrawn line of credit to be included in capital subject to certain restrictions. In the United Kingdom, subordinated loans may not exceed four hundred percent of net worth less intangible assets. *Id.*

⁹⁰ These include Australia (no limit), Singapore (regulators can approve up to one hundred percent of paid capital), Hong Kong (guidelines suggest up to two hundred and fifty percent of shareholder funds), and Switzerland (up to twenty-five percent of required capital). But note, no subordinated loans can be counted as part of capital in Germany. See GAO, SECURITIES MARKETS 92-41, *supra* note 79, at 61.

⁹¹ France counts bank guarantees for members of the stock exchange and MATIF; this practice developed because of high base capital requirements. The regulatory authority must approve the use of guarantees and total guarantees may not exceed three times net worth. IOSCO, *Remarks*, *supra* note 29, at 7.

⁹² Guarantees may not exceed thirty percent of a firm's base capital and, if drawn upon, funds may not be repaid if repayment would cause the firm to breach capital requirements. *Id.*

⁹³ See *id.* at 4. Presumably, France and the United Kingdom would offer a similar rationale for the use of guarantees.

⁹⁴ IOSCO, *Base Capital Requirements*, *supra* note 32, at 1. According to a survey in that paper (valid as of October 1990), minimum requirements were DM 3 million for German universal banks, Lira 50 billion for merchant bank subsidiaries of Italian commercial banks, FF 25 million for French brokerage firms, \$25,000 for U.S. security firms using the indebtedness method and \$100,000 for U.S. security firms using the alternative method, \$75,000 for Canadian security firms for members of self-regulatory organizations and \$25,000 for others. *Id.*

⁹⁵ See, e.g., 17 C.F.R. § 240.15c3-1(a)(1) (U.S. indebtedness method mandating minimum of \$25,000).

⁹⁶ See IOSCO, *Base Capital Requirements*, *supra* note 32, at 2; GAO, SECURITIES MARKETS 92-41, *supra* note 79, at 54-56.

The base requirement in Japan is 25% of securities firms' operating expenses excluding certain items that are easily adjustable (commissions and bond interest). GAO, SECURITIES MARKETS 92-41, *supra* note 79, at 29. In the United Kingdom, the base requirement is

sets handled,⁹⁷ the number of professional negotiators,⁹⁸ or business requirements.⁹⁹ Minimum capital requirements are primarily designed to ensure that securities firms' obligations to clients are fully met and to serve as a cushion or a threshold level, below which securities regulators may intervene to forestall a financial crisis. Generally, risk-based capital requirements will lead to a level higher than mandated minimum levels, which constitute a floor to capital.

Like the United States, France, Japan, and the United Kingdom use a haircut method to assess risk-based capital requirements on debt and equity securities on the securities firms' own positions. For equity securities, the United Kingdom has three methods for calculating haircuts: (1) a simple approach that gives no allowance for hedging or diversification (Equity Method 1); (2) an approach that gives allowances for hedging and diversification of holdings in a given market (Equity Method 2); and (3) an approach that gives allowances for diversification of portfolios that hold United States, United Kingdom, and Japanese securities (Equity Method 3).¹⁰⁰ The United States has two methods: (1) the basic or indebtedness method; and (2) the alternative method. France and Japan apply only one system of haircuts to equity securities.¹⁰¹

Securities regulators take into account the liquidity of the markets in setting haircuts on equities. In the United States, securities without a ready market receive a haircut of 100% while those with a ready market receive a haircut of 30% under the basic method or 15% under the alternative method. France,¹⁰² the United Kingdom, and Japan¹⁰³ have graduated requirements; haircuts are 10% to 25% on marketable securities and 100% on unmarketable securities. The United States,¹⁰⁴ France,¹⁰⁵ Japan, and the United Kingdom¹⁰⁶ also require additional haircuts when a securities firm holds a significant

the highest of an established minimum for that type of firm or 25% of adjusted annual expenses (one twelfth for clearing firms). *Id.*

⁹⁷ See IOSCO, *Base Capital Requirements*, *supra* note 32, at 2 (referring to France).

⁹⁸ See *id.* at 3 (referring to Ontario's requirement that includes a sum for each specialist, market maker, or trader).

⁹⁹ See *id.* (referring to U.S. alternative method, which, under 17 C.F.R. § 240.15c3-1(f), requires security firms to have the greater of \$100,000 or 2 percent of customer related receivables).

¹⁰⁰ IOSCO, *Equity Position Risk*, *supra* note 30, ¶ 7.

¹⁰¹ *Id.* ¶ 8.

¹⁰² Haircut is 12.5% for "most liquid" securities and 20% for "other marketable" securities. See *id.* ¶ 14 (noting proposed changes that took effect after the date of the paper).

¹⁰³ Haircuts depend on which section of an exchange a security is traded. First section securities receive a 10% haircut, second section issues receive a 15% haircut, and marketable securities traded over the counter receive a 25% haircut. See IOSCO, *Equity Position Risk*, *supra* note 30, ¶ 14.

¹⁰⁴ If firm holdings of one issuer's security exceeds 10% of its net capital, the firm has an additional 15% haircut on the excess. *Id.* ¶ 26. Also, if a firm has enough securities of a publicly traded company to exercise actual or legal control, it may be barred from selling the security. *Id.*

proportion of an issue. The rationale is that the firm might have difficulty liquidating such positions rapidly.

For equity securities, securities regulators take different approaches toward haircuts when both long and short positions are held and when trading strategies involving arbitrage, hedging, and derivatives are pursued. Some regulators allow reduced haircuts if a position is taken in a basket of stocks and an offsetting position is taken in an index future.¹⁰⁷ Others will allow reduced haircuts only for short and long positions in the same types of securities.¹⁰⁸ Generally, securities regulators approach hedging firm portfolios, hedging specific positions, and arbitraging between baskets of stock and index futures in very different ways.¹⁰⁹

For debt securities, haircuts in the United States, Japan, and the United Kingdom are determined according to the type of issuers and maturity.¹¹⁰ In these countries, the longer the maturity and thus the higher the volatility, the greater the risk weight. For domestic government bonds, haircuts are virtually the same in Japan, in the United Kingdom and in the United States.¹¹¹ Yet, haircuts vary considerably on corporate bonds.¹¹²

Each country has different offset rules for debt securities that

¹⁰⁵ In France, a security firm's net exposure to a particular issuer should not exceed 40% of the net shareholders' funds of the firm. *Id.* ¶ 25.

¹⁰⁶ Under U.K. and Japanese rules, a firm's exposure to one issuer is "concentrated" if it exceeds 25% of the firm's adjusted net liquid assets. Additional haircuts are required on concentrated exposures. *Id.* ¶ 24.

¹⁰⁷ See *id.* ¶ 18 (referring to French and Japanese requirements).

¹⁰⁸ In the United States, for example, there would be no requirement on short positions totalling up to 25% of long positions. But, there would be a haircut on the excess of the short position over this percentage. See IOSCO, *Equity Position Risk*, *supra* note 30, ¶ 19 (referring, for the United States, to the net capital rule, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(j)). The United States believes that there is a specific risk associated with short positions (for example, short squeezes). The United Kingdom also reduces haircuts for balanced books. See *id.* ¶ 21.

¹⁰⁹ See generally, *Capital Treatment of Certain Arbitrage Positions*, compiled in *Papers Relating to Capital Adequacy of Securities Firms*, Division of Market Regulation, U.S. Securities and Exchange Commission (1991) (submitted to the Technical Committee of the International Organization of Securities Commissions for the July 16-17, 1991 meeting in Paris, France (1991) (including proposals for capital requirements on arbitraging and hedging strategies, including: ADRs against common stock, convertible securities against common stock, warrants on the shares of individual companies against common stock, index warrants against a basket of common stock, stock index options and futures on a basket of common stock, and forward contracts against an individual common stock).

¹¹⁰ See *Comparison of Position Risk Requirements for Debt Securities*, compiled in *Capital Requirements for Multinational Securities Firms*, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATIONS OF SECURITIES COMMISSIONS, at 1-3, (1990) (XV Annual Conference of IOSCO in Santiago, Chile, Tome 1) [hereinafter IOSCO, *Debt Position Risk*].

¹¹¹ For a government bond with a maturity of less than three months, the haircut would be 0% in the United States, .2% in Japan, and .25% in the United Kingdom. For a government bond with a maturity of twenty-five to thirty years, the haircut would be 3.5% in the United Kingdom, 5% in Japan, and 6% in the United States. *Id.* at 8, Annex A.

¹¹² Each country defines what debt security "qualifies" as a high grade corporate security or, as in the United States, whether the security is deemed non-liquid because there are not enough market makers. For good quality corporate bonds maturing in more than

would permit lower haircuts on simultaneous holdings of long and short positions of a government or high quality bond.¹¹³ The rules also vary with respect to the extent to which offsets on different issues of government bonds with a similar maturity will be allowed and with respect to whether offsets on different issues of government bonds with different maturities will be allowed. For derivatives on debt instruments, each country has different rules on the treatment of financial futures, options, or interest rate products.¹¹⁴

B. Toward an IOSCO Consensus on Security Firm Capital

In 1989, IOSCO's Technical Committee issued a concept paper outlining a plan to establish a common framework for regulating securities firms. IOSCO recommended that securities regulators:

- Establish risk-based capital requirements that include a base capital requirement linked to the size and nature of the firms activities, a position risk requirement on firm holdings of securities, and a settlement risk requirement to reflect the risk of nonperformance of a contract to buy or sell;
- Limit the amount of financing, relative to owner's equity, that can be considered as capital;
- Develop standard minimum capital requirements based on the firm's type of business and dealings with customers; and
- Routinely examine securities firms to ensure compliance with financial responsibility, capital adequacy, and record keeping requirements.¹¹⁵

At the 1990 annual meeting of IOSCO, the Chairman of the Technical Committee¹¹⁶ summarized a study that focused mainly on comparing capital requirements for nonbank firms in France, Japan, the United Kingdom and the United States. That study also focused on the definition of capital, base and minimum capital requirements, debt position risks and equity position risks. The Chairman of the SEC, elected as the new chairman of the Technical Committee in

twenty-five years, the haircuts are 6.5% in the United Kingdom, 8% in Japan, and 9% in the United States. *Id.* at Annex B.

¹¹³ See *id.*

¹¹⁴ See *id.* For example, "[i]n one country, only exchange traded derivative instruments are allowed as an offset against the underlying cash instrument. In the case of options, three of the countries consider whether the option is likely to be exercised. In those countries in which investment firms do interest rate swaps, the rules treat swaps for the purposes of market risk as notional government bonds." *Id.*

In the case of options on debt or equities, some regulators consider whether the option will be exercised. Regulators sharply disagree on how to access capital charges against options. Some regulators strongly support the use of financial models as a basis for assessing risks and capital charges, while the United States argues for its system of haircuts based on specific strategies. For an explanation of the U.S. position see Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW 863, 882 (1992).

¹¹⁵ See IOSCO, INITIAL REPORT, *supra* note 16, at 5.

¹¹⁶ See Remarks by Jeffrey Knight, compiled in *Capital Requirements for Multinational Securities Firms*, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, (1990) (XV Annual Conference of IOSCO in Santiago, Chile, Tome 1) [hereinafter *IOSCO, Capital Requirements*].

1990, stressed the importance of devising ways to harmonize bank and security firm capital adequacy requirements to prevent the emergence of "unfair competitive advantages."¹¹⁷

At the September 1991 annual meeting, IOSCO issued the *Memorandum from IOSCO's Technical Committee on Banking Supervision*.¹¹⁸ The Memorandum describes the areas of agreement among securities regulators and sets forth principles by which they would agree to harmonize securities regulations with bank regulations. The Memorandum focused mainly on position risk and defining some elements of capital, rather than on base capital or minimum capital levels.

1. Definition of Capital for Securities Firms

Securities regulators firmly believe that securities firms that take large proprietary trading positions or that act as dealers should be able to count their use of short-term subordinated loans as part of capital.¹¹⁹ The use of subordinated loans, where allowed, is subject to strict lock-in restrictions that prohibit repayment by securities firms at maturity if it would bring the firm's capital below a threshold level.¹²⁰ Regulators stressed that access to such loans can boost capital bases quickly in response to changing market or counter-party risks and facilitate securities firm compliance with capital requirements. In addition to the "lock-in" provisions, a majority of the Technical Committee¹²¹ indicated that it would be willing to accept, as part of an international agreement, an upper limit on the use of subordinated loans of 250% of equity capital and retained earnings. The upper limit is equivalent to about 70% of a firm's total equity capital plus subordinated loans.¹²² These limits parallel those of the SEC.¹²³

A majority of Technical Committee members also indicated that there was no need for sub-limits, referred to as inner limits, within the 250% limit on subordinated capital on the use of loans from unregulated group entities and entities outside the group. Three countries, France, Germany, and Switzerland, disagreed with the majority because the absence of inner limits would permit securities firms greater access to intra-group loans than allowed for banks and a

¹¹⁷ GAO, SECURITIES MARKETS 92-41, *supra* note 79, at 33.

¹¹⁸ IOSCO *Memorandum*, *supra* note 1, at 1-8.

¹¹⁹ Two members of the Technical Committee expressed concern about including subordinated loans as part of capital and would prefer a definition of capital that is closer to that specified by the Basle Committee. *See id.*

¹²⁰ For example, in the United States, payment would not be permitted if it would, together with any other payments scheduled for the next six months, reduce net capital below 1200% of the minimum required level for net capital or fail to meet other rigid requirements. 17 C.F.R. § 240.15c3-1d(b)(8).

¹²¹ *See IOSCO Memorandum*, *supra* note 1, at y (two members dissenting).

¹²² *See supra* text accompanying note 75.

¹²³ *See* 17 C.F.R. § 240.15c3-1(d).

group with unregulated entities could artificially inflate its capital.¹²⁴ This dispute arises because pure securities firms would have a lower cost of capital than security firms in the form of universal banks, which are subject to Basle capital requirements that mandate a subordinated debt limit equivalent to 50% of equity capital for banks.¹²⁵ The majority of Technical Committee members pointed out that the artificial capital argument could arise without inner limits because an unregulated entity in a group could issue short term paper and convert it into equity capital in the regulated entity. The majority argued, therefore, that the appropriate solution lay in better supervision of financial conglomerates.

2. *Comprehensive or Building Block Approach*

The securities regulators in major markets use the comprehensive approach¹²⁶ that endeavors, through haircuts, to capture specific and general market risks in one risk weight. Adverse price movements arising from factors linked to the issuer give rise to "specific" risks. Adverse price movements that are unrelated to an issuer are "general" market risks.¹²⁷ In contrast, proposals of the Basle Committee Working Parties recommend an approach that separates specific and general market risks related to traded securities.¹²⁸ This approach is called the building block approach, which includes "X" capital charges for specific risks and "Y" capital charges for general risks. Nonetheless, most securities regulators seem willing to accept the building block approach for both equity and debt securities.¹²⁹

Some members of the Technical Committee agreed that the building block approach would be acceptable for securities firms, provided that it was implemented with a transition period.¹³⁰ The Japanese Security Bureau stated that it would prefer to maintain the comprehensive approach and retain Japan's capital adequacy rules that went into effect in 1990. Nonetheless, Japan indicated a willingness to adopt the building block approach if everyone else did.¹³¹

The SEC stated that it would not give up the comprehensive approach, as implemented in its net capital rule, although it "would

¹²⁴ See *IOSCO Memorandum*, *supra* note 1, at 5. There was also disagreement about whether there should be limits on capital from outside of a group. Some felt that a trigger of the lock-in provisions would alert lenders to a potential problem, while others felt that it was a sign of strength that lenders would provide funds subject to a lock-in provision.

¹²⁵ See *Basle Accord*, *supra* note 2.

¹²⁶ At least, France, Japan, the United States, and the United Kingdom. See *supra* text accompanying note 87. German universal banks fall under bank regulation based on the principles of the Basle Accord. See *supra* text accompanying note 38; see also GAO, *SECURITIES MARKET* 92-41, *supra* note 79, at 56.

¹²⁷ See *IOSCO, Equity Position Risk*, *supra* note 30.

¹²⁸ See *IOSCO Memorandum*, *supra* note 1, at 8.

¹²⁹ *Id.* at 3.

¹³⁰ *Id.*

¹³¹ *Id.*

support the use of the building block approach as a means of expressing a minimum standard."¹³² The SEC supports the comprehensive approach with its use of haircuts and limits on leverage because it has provided an "accurate and financially responsible safety margin against the risks to which broker dealers holding equity positions have been exposed, especially in times of market stress."¹³³ Obviously, a similar capital standard could, in theory, be established by using a one-step (a comprehensive) approach or a two-step (a building block) approach. The debate reflects different capital requirements among countries and variances between banks and nonbank security firms. The issue is not merely what level of capital should be assessed against proprietary trading of securities firms, which, for example, differ in the United Kingdom and the United States. It is also a question of against what activities the capital requirements should apply. For banks and countries like Germany with a universal banking system, capital requirements are assessed against all assets. In contrast, in some countries without universal banking, regulators only apply a system of haircuts to the securities firms' own securities positions, although other limitations, such as those on the amount of subordinated debt, can act as a prudential curb on the firms' abilities to expand and to engage in risky activities.

3. Debt Position Risk for Securities Firms

Debt position risk arises when a securities firm holds debt securities of other firms for its proprietary accounts. The main issues cited in the 1991 IOSCO Memorandum relate to what constitutes a qualifying security and what offset rules should apply.¹³⁴ A qualifying security is generally an easily marketable, high-grade corporate security.¹³⁵

¹³² *Id.*

¹³³ See *Equity Securities*, compiled in *Papers Relating to Capital Adequacy of Securities Firms*, Division of Market Regulation, U.S. Securities and Exchange Commission, at 70-71 (1991) (submitted to the Technical Committee of the International Organization of Securities Commissions for the July 16-17, 1991 meeting in Paris, France, 17 (1991)) [hereinafter SEC, *Equities Paper*].

¹³⁴ See *IOSCO Memorandum*, *supra* note 1, at 6-7. Note that there was also an issue of whether bonds should be placed into the regulatory scheme for capital charges based on duration or residual maturity. Duration is a weighted average time to payment of interest and capital. Duration is generally used to measure the sensitivity of bond prices to interest rate changes. The SEC is against the use of duration for regulatory purposes, but the rest of the Technical Committee appears willing to consider accepting duration as an alternative methodology. See *id.* at 7.

¹³⁵ See *IOSCO, Debt Position Risk*, *supra* note 110. Japan and the United Kingdom classify, and assign risk weights to, bonds as government, qualifying or high quality corporate, and other. The United States classifies, and assigns risk weights to, bonds as government or government guaranteed, municipal, Canadian Government, nonconvertible debt issues rated in one of the top four categories, and others (those bonds that have at least two market makers). *Id.* The Carosio group would have allowed offsetting rules to apply to junk bonds; the U.S. SEC treats junk bonds like equities. See SEC, *Equities Paper*, *supra* note 133, at 91; *Capital Adequacy Standards for Positions Subject to Interest Rate Risk*, compiled in *Papers*

The Carosio group, a Basle Committee subgroup, recommended a building block approach. Each bond would be assigned a risk factor for specific risk (X) and general market risk (Y); the two risk factors together would then be added to derive a capital charge for a bond within a given maturity band.¹³⁶ Capital charges for market risks could be substantially reduced by taking offsetting positions; the charges for specific risks would remain unchanged. The Carosio group proposed the adoption of three zones, with thirteen sub-zones or bands.¹³⁷ The maturities would be up to one year in Zone One, up to four years in Zone Two, and more than four years in Zone Three. A long and short position could be almost completely offset within the same time band.¹³⁸ A long and short position between zones could be offset, but to a lesser degree.¹³⁹ Offsetting within the same maturity band is called vertical offsetting, while those in different bands are called horizontal offsetting. Effectively, some degree of offset would be permitted for hedging a long position in any bond of any maturity with a short position in any other bond of any maturity. The underlying assumptions are that (1) interest rates on all debt instruments change in the same direction at the same time; and (2) changes in the market value of bonds in one maturity will offset those of another security with a different maturity.¹⁴⁰

In response to the Carosio proposals, the SEC proposed the

Relating to Capital Adequacy of Securities Firms, Division of Market Regulation, U.S. Securities and Exchange Commission, at 70-71 (1991) (submitted to the Technical Committee of the International Organization of Securities Commissions for the July 16-17, 1991 meeting in Paris, France (1991)) [hereinafter SEC, *Debt Paper*].

The Technical Committee appeared willing to expand the definition of qualifying issues to include securities issued by banks that meet the Basle Capital Adequacy Standard. The Technical Committee's proposal is broader than the current definition in some countries, because not all banks of high quality have their debt securities rated or listed. But, it is narrower than the definition proposed by the Carosio Working Party, a working party of the Basle Committee, because not all banks' securities would be considered qualifying. See *IOSCO Memorandum*, *supra* note 1, at 7.

¹³⁶ See *IOSCO Memorandum*, *supra* note 1, at 3, 6-7.

¹³⁷ See SEC, *Debt Paper*, *supra* note 135, at 16.

¹³⁸ The U.S. net capital rule permits a long position and a short position within the same time band to be completely offset each other. The Carosio group says that they will offset each other, subject to a disallowance of 10% on one side. The rationale for the Carosio approach is that even bonds of the same maturity might not have exactly the same correlation, or tendency for prices to change in exactly the same way. According to SEC calculations, the resulting capital requirement on bonds within the same time band would be virtually the same as that resulting from capital charges based on a complete offset. See *id.* at 40-42.

¹³⁹ The disallowance factor is 30% between adjacent zones and rises to 100% between zones One and Three. These disallowance factors still permits offsetting between zones. For example, if there was a \$100 general market risk charge on a long position in a bond in zone One and a \$100 charge on a short position in bond in zone Three, the disallowance of 100% of one side would leave a \$100 capital charge. This charge is half of what the result would be if no offsetting were allowed. See *id.* at 16-17 n.6.

¹⁴⁰ See *id.* at 5.

adoption of a building block methodology and the use of zones of different maturities.¹⁴¹ But, the SEC urged a rolling band approach. A bond in one maturity band could be offset with a bond that fell within a limited maturity range above and below the band.¹⁴² Progressively lower degrees of offsetting would be permitted as the maturity band of a bond was farther away from the maturity band of the bond to be offset. No offsetting would be permitted between bonds with maturities of more than a certain number of bands apart or between Zones One and Three.¹⁴³ A majority of the Technical Committee members rejected the Carosio proposals on offset rules because the proposals would lead to substantial reductions in the amount of capital required by securities regulators¹⁴⁴ on portfolios containing long and short positions in securities. The majority¹⁴⁵ supported offset rules along the lines of those proposed by the SEC.

4. *Equity Position Risk for Security Firms*

Equity position risk arises when a securities firm holds equities of other firms for its proprietary account. A majority of the Technical Committee was willing to accept an approach that sets both a minimum percentage of capital on the gross position and on the net position. This approach is called the "X + Y approach."¹⁴⁶ Under this approach, a minimum standard of 4% on the gross position, needed to cover specific risk inherent to a particular security and 8% on the net position, needed to cover the general market risk, would apply to diversified portfolios of highly liquid or qualifying equi-

¹⁴¹ *Id.* at 1-2, 90. In the United States, the net capital rule divides government securities into four categories based on maturity (which are further divided into subcategories) and nonconvertible, highly rated corporate debt into nine bands. Within each subcategory of government bonds, the SEC allows a complete offset between long and short positions so that a capital charge would only be assessed against the net position. Partial offsetting of capital charges (or haircuts) is then permitted within a category, and, in limited cases, between categories. Offsetting is also permitted on highly rated nonconvertible corporate debt. Within certain limits, capital charges on corporate debt may also be offset by government bonds. *Id.* at 20-26.

The SEC proposal was aimed at increasing capital charges from levels proposed by the Carosio group by reducing the offset opportunities between bands of different maturities. *See id.* at 90.

¹⁴² *See id.* at 91.

¹⁴³ *Id.*

¹⁴⁴ Notably those in Japan, the United Kingdom, and the United States. *See IOSCO Memorandum, supra* note 1, at 6.

¹⁴⁵ Three countries, however, expressed reservations. Germany stated that it could accept the SEC proposal as a compromise. Australia, which tends to favor tighter offset rules than the SEC, stated that it could not yet endorse the SEC proposal because regulators had not yet tested the proposals using data from Australian markets. France would prefer the Carosio proposals and expressed the view that the SEC proposal was too harsh with respect to the ban on offsetting between maturity zones one and three, the level of the vertical disallowance factor in zone one, and the fact that vertical disallowances differ among zones. *See id.* at 6.

¹⁴⁶ This approach was one discussed by the Barnes Working Party. *See id.* at 8.

ties.¹⁴⁷ That is, the capital requirement would be 4% of the value of the long position, 4% of the value of the short position, plus 8% of the net position. Thus, for a portfolio with a long position of \$100 and a short position of \$100, the capital requirement would be \$8 as calculated by 4% of \$100 (the long position) plus 4% of \$100 (the short position) plus 8% of \$0 (\$100-\$100, or the long position less the short position).¹⁴⁸ A portfolio with a long position of \$100 and no short position would have a capital requirement of \$12 (4% of \$100 long position plus 4% of \$0 short position plus 8% of \$100 net position). A portfolio that is balanced with both short and long positions has a lower capital requirement than a portfolio with only a long position. The rationale is that a balanced portfolio is less risky.¹⁴⁹ Despite the emergence of an apparent consensus, considerable disagreement among the securities regulators still exists. For example, regulators noted that global equity markets are not homogeneous and suggested that the $X + Y$ approach fails to take into account political risk, the varying degrees of volatility and liquidity in different markets, the variety of market structures, and other unique local features.¹⁵⁰

Regulators did not agree on the extent to which capital charges should be lowered when portfolio diversification reduces the riskiness of portfolios.¹⁵¹ France, Japan, and the United Kingdom consider that the "four plus eight" standard is too high and overstates

¹⁴⁷ For other equities, the minimum standard would be 8% of the gross position and 8% of the net position. *Id.*

¹⁴⁸ See SEC, *Equities Paper*, *supra* note 133, at 21-22, Exhibit A.

¹⁴⁹ See *id.* at 6; IOSCO Annual Conference: Technical Committee Sends Capital Memorandum to Banking Supervisor, INT'L SEC. REG. REP. (Oct. 7, 1991).

¹⁵⁰ See IOSCO Memorandum, *supra* note 1, at 8.

¹⁵¹ Portfolio theory is based on the proposition that an investor can get higher returns if he doesn't put all of his eggs in one basket. The demand for financial assets are a function of risks and expected return. The risks arise because the future price cannot be predicted accurately, that is, prices follow a random walk. See KENNETH GARBADE, *SECURITIES MARKETS* 134, 241-265 (1982). The random walk theory has also been expressed as the idea that "Prices have no memory and yesterday has nothing to do with tomorrow." See SEC, *Equities Paper*, *supra* note 133.

The return on an asset may be the same as another asset, in which case, the returns would be perfectly correlated. If the price of one asset goes up and the price of a second asset falls by the exactly the same amount, then the returns are have a perfect negative correlation and the risk of this two asset portfolio would always be zero. Mathematically, it can be shown that holding a portfolio of assets, rather than one asset, will reduce risks even when the returns on the assets a zero or an arbitrary correlation. See GARBADE, *supra*, at 134.

Portfolio theory serves as a foundation for evaluating whether financial markets are efficient. If investors do not make use of all available information in forming their expectations on the return of assets, then equilibrium prices will not fully reflect all relevant information and some investors can earn abnormally high returns by exploiting information ignored by others. If information about past patterns of securities prices (or historical information) does not improve an investor's ability to predict future prices, then the market is weak-form efficient. If expectations of future prices have been formed on the basis of all information in the public domain (and not just historical information), then the market is semi-strong efficient. If no information exists that could be used to improve an

the risks in diversified portfolios. The SEC maintains that lower capital requirements based on portfolio diversification theory are not appropriate because: (1) not all risks are reduced through diversification; (2) it is unclear what constitutes a sufficiently diversified portfolio; and (3) it would be extremely complicated to administer a capital rule that required regulators to assess whether portfolios were adequately diversified.¹⁵²

Regulators have conceded to disagreement in other areas as well.¹⁵³ Individual regulators have discretion to define what constitutes qualifying equities and diversified portfolios.¹⁵⁴ Regulators agree that arbitrage activities will require separate treatment and that this issue should be resolved in another IOSCO sub-committee.¹⁵⁵ Finally, Japan said that it would adopt the standard if all parties agree to it, while the United States has said that it will maintain its net capital rule, but ensure that capital requirements meet or exceed the agreed upon standard.¹⁵⁶

C. *Is IOSCO Headed in the Right Direction?*

IOSCO seeks to harmonize standards of capital adequacy in the major securities markets by setting common minimum levels. If successful, the commonality approach could appropriately set a floor below which neither competition nor regulatory arbitrage could force international regulation and establish a basis for prudential regulation to mitigate systemic risks.¹⁵⁷

In its September, 1991 Memorandum, IOSCO ostensibly made

investor's return, then the market is strong form efficient. It appears that financial markets may be semi-strong form efficient, but not strong form efficient. *See id.* at 265.

¹⁵² The SEC argues that not all portfolio risk can be reduced through diversification. The SEC finds that there is "valuation risk" stemming from market inefficiency in determining a stock's inherent value and from unexpected future developments that affect a stock's inherent value. The SEC might be saying that the market is not strong-form efficient because it does not incorporate insider information. The SEC also maintains that there is "volatility risk;" or the risk of substantial market movement during periods of market stress. *See SEC, Equities Paper, supra* note 133, at 7. Note, the SEC also believes that "an international capital standard should provide adequate coverage for the worst days and the most aggressive trading firms, not just representative days or portfolios." *Id.* at 31 (discussing why the 2/8 version of the building block approach was inadequate).

¹⁵³ *See IOSCO Memorandum supra* note 1, at 8.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ The contra argument is that the costs of harmonization could inhibit the development of new or hybrid financial products and could be costly generally if capital requirements are too high. U.S. Commodities Future Trading Commission's Commissioner Albrecht urged the abandonment of harmonization in favor of continued competition. He suggested that "the CFTC favors a policy of combining national treatment with mutual recognition." *See OTA, TRADING AROUND THE CLOCK, supra* note 39, at 79. Such a principle would, for example, permit a foreign firm to operate in the United States if it complied with the regulations of its country of origin and the rules of the country of origin and the United States were comparable. *Id.*

progress among securities regulators toward establishing a definition of capital and a minimum level of capital for position risks. The apparent consensus, however, may be a mirage; the EC members of IOSCO released a revised version of proposed EC rules on capital adequacy that differs from the IOSCO Memorandum.¹⁵⁸ The IOSCO Memorandum also did not address how to harmonize regulations between securities firms, which would face IOSCO rules, and universal banks, which would face IOSCO rules on securities activities and Basle capital adequacy rules on all assets. Significant progress appears to have occurred at IOSCO's January, 1992 meeting; a consensus may be emerging that would effectively strip out the securities activities from banks and subject them only to IOSCO rules.¹⁵⁹

Other issues include whether the use of two parallel systems, a comprehensive and a building block approach, will make already complex securities regulation even more complicated. By establishing minimum standards expressed in either approach, however, the parallel use of both approaches might reduce the potential for regulatory arbitrage between major international banks that use the Basle Committee approach and securities firms. Additionally, the risks of securities firms and other market intermediaries may be vastly different. Dealers, who take positions, for example, need more capital than brokers, who match orders. To some extent, these differences are taken into account when regulators set different minimum capital levels.

IOSCO seems to be working to develop a consensus in which minimum levels of capital are specified. One question that should be asked is how to determine how much capital is needed to cover risks. The assumption that past volatility or past market stress is an indicator of future market stress should be closely examined. Regulators also need to assess and to recognize the degree to which trading strategies and derivatives reduce securities firms' risks.

¹⁵⁸ See Amended CAD, *supra* note 6. For example, the January version of the EC proposal would have permitted a lower amount of non-equity finance to count toward security firm capital. The June version would permit the same amount of subordinated debt as the IOSCO Memorandum. See *infra* text accompanying note 194.

¹⁵⁹ See Joint Statement, *supra* note 4, at 2. The statement says that:

- (1) with respect to holdings of traded debt securities, the building block approach would be used by all regulators and regulators from only one country had reservations about minimum levels of capital and definitions of off-setting rules;
- (2) with respect to equity securities, bank supervisors and some securities supervisors would use the building block approach, while other securities supervisors would continue to use the comprehensive approach and would demonstrate that their requirements would equal or exceed capital requirements under the building block approach; and
- (3) regulators would consider some provision in the definition of capital for banks' trading portfolios so that permitting the use of subordinated debt for securities portfolios would not give securities firms an advantage over banks.

IV. IOSCO Consensus v. Basle Accord

One handicap to developing consistent securities regulation is that banks engage in activities that resemble those undertaken by securities firms.¹⁶⁰ Perhaps the best method of overcoming this handicap would be to segregate the bank's securities portfolio and apply securities regulation to these activities, although this may involve thorny, political problems of how to get domestic bank and securities regulators to coordinate regulation.¹⁶¹ Another option is to harmonize regulations so that the entity, whatever its form, maintains enough capital and follows enough prudent practices to maintain the safety and soundness of the financial system. This approach fails to address level playing field issues between banks and securities firms, domestically and internationally.

Regulators have considered both solutions. For example, U.S. regulators mandate that securities transactions of banks take place in a subsidiary.¹⁶² At the international level, banks and securities regulators are considering ways to harmonize regulations. This section first examines bank regulation and then compares it with the consensus emerging among securities regulators.

A. Bank Regulatory Harmonization: The Basle Accord

In July of 1988, regulators from the Group of Ten countries¹⁶³ endorsed the Basle Committee¹⁶⁴ proposal establishing a common framework for international bank supervision. The framework only focused on credit risks. It did not focus on market risks related to changes in interest or foreign exchange rates or on the disparate treatment of banks because of different tax and accounting regimes; rather the Accord envisaged future work toward establishing a common framework in these areas.¹⁶⁵ The main elements of this Accord were to:

- define the elements of capital, which was divided into (1) core, or "tier 1," capital in the form of equity capital and disclosed reserves and (2) supplemental, or "tier 2," capital in the form of undisclosed reserves, general provisions, subordinated loans, and hybrid debt/capital instruments;
- assign credit risk weights to various types of exposure;

¹⁶⁰ See *supra* text accompanying notes 36-47.

¹⁶¹ This solution could involve two different types of regulators examining one entity, unless the entity is a universal bank so that a single regulator could propound rules or the bank is one entity in a group and the securities firm is another entity so that two regulators would examine two separate entities.

¹⁶² See GAO, *SECURITIES SUBSIDIARIES*, *supra* note 47, at 2-3, 11.

¹⁶³ The Group of 10 is comprised of: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and the United States. See *Basle Accord*, *supra* note 2.

¹⁶⁴ *Id.*

¹⁶⁵ See *id.* Nonetheless, some market risk is effectively taken into account by the Basle Accord's treatment of off-balance sheet items.

- set a minimum standard for the ratio of capital to risk weighted assets; and
- provide for a transition period, with full implementation to be completed by January 1, 1993.¹⁶⁶

By January 1, 1993, international banks are required to have capital equivalent to 8% of their risk-weighted assets, of which Tier Two capital could not exceed four percent.¹⁶⁷ In addition, subordinated debt cannot count for more than the equivalent of 50% of Tier One capital, only part of unrealized capital gains can be counted as part of Tier Two capital¹⁶⁸ and only a limited amount of general provisions/loan loss reserves can count as capital.¹⁶⁹ The Basle Committee considered that subordinated debt had the drawback of having a "fixed maturity and inability to absorb losses except in liquidation."¹⁷⁰

Regulators intended that the scheme of assessing capital against risk-weighted assets be relatively simple to apply, despite differences in the structure of banks in different countries. Regulators also intended to incorporate the risk of both on-balance-sheet (*e.g.* loans) and off-balance-sheet (*e.g.* commitments and guarantees) activities and not to deter banks from holding liquid assets.¹⁷¹ The scheme classifies assets by the type of counterparty into four risk weights: zero, twenty, fifty and one hundred percent.¹⁷² Thus, for example, cash and claims on central governments receive a 0% weight, while riskier loans to the private sector receive a 100% weight.¹⁷³ Off-balance-sheet items are first converted into credit risk equivalents by multiplying the principal amounts by a credit conversion factor; the risk-weights are then applied to these equivalents.¹⁷⁴

Under the Basle Accord, bank or publicly guaranteed loans or assets collateralized by cash or securities issued by certain public entities are assigned the risk-weight of the bank or the public entity, rather than the borrower. The Basle Accord also provides for a

¹⁶⁶ *Id.* To assign credit risk weights, a system was developed consisting of five risk weights, ranging from zero to one hundred percent, that were assigned to different types of assets (cross-border loans, governmental entities, collateral and guarantees, residential property mortgages, off-balance sheet engagements). *See id.*

¹⁶⁷ The limit is expressed as "The total of Tier 2 (supplementary) elements will be limited to a maximum of 100 percent of Tier 1 elements." *See id.*

¹⁶⁸ Only 45% of the difference between the historic book cost and the market value can be counted as tier 2 capital. This limit is expressed as "In the case of 'latent' revaluation reserves a discount of fifty-five percent will be applied to the difference between historic cost book value and market value to reflect the potential volatility of this form of unrealized capital and the notional tax charge on it." *See id.*

¹⁶⁹ This limit is expressed as "general provisions/general loan loss reserves will be limited to a maximum of one and one quarter percentage points, or exceptionally and temporarily up to two percentage points, of risk assets." *See id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

crude assessment of country risk in applying its risk-weights to cross-border bank assets. Loans to central governments and other sovereign entities of OECD countries receive a lower risk-weighting than those of non-OECD countries.¹⁷⁵ The Basle Accord explained that foreign exchange and interest rate contingencies needed special treatment because "banks are not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flow . . . if the counterparty defaults."¹⁷⁶ The Accord contains two methods of dealing with the credit risk of these contingencies: (1) mark the value of the contingencies to market and then add an amount to reflect the potential future exposure, or (2) apply a factor to the amount of the original exposure. The second approach reflected the view, held by a minority of regulators, that the marked-to-market approach was inconsistent with the rest of the capital adequacy framework of the Basle Accord.

The Basle Accord was not automatically imposed on each country. Countries had to adopt the framework into their own law.¹⁷⁷ By September 1990, countries with the main financial centers adopted the framework set forth in the Basle Accord.¹⁷⁸ As part of the efforts to create a single European market, the EC adopted three key banking Directives that are generally consistent with the Basle framework.¹⁷⁹

B. Basle Accord and IOSCO Consensus: A Comparison

The first key difference between the traditional roles of bank and securities regulators lies in the type of assets and accounting of the entities that they regulate. Loans and other bank assets are generally not easily marketed assets and are not carried on bank books at market value.¹⁸⁰ In contrast, securities held, traded, or sold by securities firms generally are marketed easily and have an easily ascertainable

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ Some countries have supplemented risk-based capital adequacy requirements with other national measures designed to constrain banks' ability to lever their capital bases. In the United States, for example, bank holding companies must maintain a minimum ratio of Tier One capital to consolidated assets. The ratio has been set at 3% for top-rated banks in good condition and at higher levels for institutions with lower ratings and those experiencing significant growth. See IMF, CAPITAL MARKETS, *supra* note 2, at 37; 12 C.F.R. §§ 208, 225 (1990); John L. Douglas, *FDIC Forced to Focus on Capital Levels*, NAT'L L.J., July 13, 1992, at 20-21 (discussing the impact of the Federal Deposit Insurance Corp. Improvement Act of 1991, Pub. L. 102-242, 105 Stat. 2236 (Dec. 19, 1991)).

¹⁷⁸ See IMF, CAPITAL MARKETS, *supra* note 2, at 36.

¹⁷⁹ Notably, the Own Funds, Solvency, and Second Banking Coordination Directives. These Directives are fairly consistent with the Basle Accord, except that unrealized capital gains cannot count as Tier Two capital. See *id.* at 36.

¹⁸⁰ The Basle Committee struggled with how to deal with collateral and new financial instruments. The Accord treats bank holding of loans collateralized by assets as private sector claims unless guaranteed by the central government; there is, however, a lower weight assigned to residential mortgage loans. Asset sales with recourse are off-balance

value. Thus, bank regulators are more concerned with credit risks relating to the borrower while securities regulators traditionally are more concerned with ways to take into account both market and credit/counterparty risks.

Reflecting these differences, securities firms value all assets to market price, thus recognizing unrealized gains and losses, but banks do not in some countries. Securities firms have a 100% haircut on illiquid or not easily marketable assets and do not count them in calculating capital,¹⁸¹ while banks still count them in risk-weighted assets.

Both the IOSCO proposal and the Basle Accord have an 8% capital requirement to protect against risks, but the base to which the capital requirement is applied and the nature of the risks included are different. For securities firms that segregate client funds, the 8% requirement is assessed against the net equity position held by the firm and is designed to protect the firm against general market risks. For banks, the 8% requirement is assessed against risk-weighted assets held on or off their balance sheets and is mainly designed to protect against defaults by their borrowers.

In short, the two regulatory schemes at present are quite different. To assess the impact of capital requirements on the two types of financial institutions, similar capital requirements would have to be applied against a similar base. Thus, for example, banks might apply the security firm requirements to their trading/securities activities. To the extent that securities firms engage in banking activities, as a universal bank or through a subsidiary, they might apply banking requirements. In fact, a press release following the January 1992 meeting of the Technical Committee of IOSCO and the Basle Committee suggested that regulators may be headed in this direction.¹⁸²

With respect to what counts towards capital, securities firms are viewed as having more access to subordinated loans with less restrictions and for shorter terms than banks do. At least two securities regulators permit the use of guarantees, whereas bank supervisors do not.¹⁸³ Banks, however, have easier access to cheap deposits and central bank funds that are not available to securities firms.

sheet items assigned a credit conversion factor of 100%; that is, the bank would apply the same risk weight as the original asset. See *Basle Accord*, *supra* note 2.

¹⁸¹ See IOSCO, *Equity Position Risk*, *supra* note 30, at 5.

¹⁸² See *supra* text accompanying note 4. But note, however, that the Basle Committee is apparently in favor of distinguishing between securities held by banks for long-term purposes, against which capital requirements might not apply, and those held for trading purposes, against which capital requirements would apply. On this point, IOSCO sharply disagrees with Basle because banks could shift securities from their trading books to their investment books, which, in fact, turnover quite rapidly. See *Disagreement Plagues Committee Discussions on Harmonized International Capital Standards*, INT'L SEC. REG. REP., July 28, 1992, at 1.

¹⁸³ France and the United Kingdom. See IOSCO, *Remarks*, *supra* note 29, at 6-7.

Whether banks or securities firms have a higher effective capital charge has not been clearly determined.¹⁸⁴ Securities firms in the United Kingdom, which are allowed to use an amount of subordinated loans equivalent to 400% of their equity, maintain that they would face a sharply higher capital charge if forced to comply with proposed IOSCO limits on subordinated debt, tighter proposed EC capital adequacy directive limits, or even stricter Basle limits.¹⁸⁵ Moreover, France and the United Kingdom are arguing that IOSCO is seeking to set specific risk charges, at least for equities, at levels that would require substantial increases in security firm capital.¹⁸⁶

Securities regulators appear to recognize that in an ideal world different capital requirements for banks/securities firms would not influence the form chosen by an entity to carry out its activities. In the 1991 IOSCO Memorandum, the Technical Committee observed that even if bank and securities regulators set a common minimum standard for market risks and definition of capital,

[S]ubstantial differences between the respective overall capital adequacy tests would remain and, as a result, some Technical Committee members point out that harmonizing the market risks alone would not create a "level playing field." They point out that securities firms could be at a competitive disadvantage if the market risk requirements for banks and securities firms were the same, but only securities firms were subjected to a base requirement and net liquid assets test. On the other hand, if all national banking requirements were taken into account, together with the Basle Convergence Accord, the balance in some countries could well be in favor of the securities firms because many banks are subject, inter alia, to high initial minimum capital requirements.¹⁸⁷

The potential for regulatory arbitrage between banks and securities firms appears to have increased as a result of financial deregulation in the major industrial countries in the 1980s. The Basle Accord attempts to develop a common capital standard for banks, while the emerging IOSCO consensus appears directed toward establishing a common capital standard for securities firms. If the two groups coordinate, the incentives for regulatory arbitrage should diminish and

¹⁸⁴ But one observer stated: "If adopted, the proposal would force nonbank securities companies to increase their capital, forcing up their costs. The proposal has sparked concern particularly in the UK, where nonbank companies dominate the securities industry." Richard Waters, *Brokers Should Meet Capital Adequacy*, FIN. TIMES, Nov. 28, 1991, at 30.

¹⁸⁵ See *id.*

¹⁸⁶ See *id.*

¹⁸⁷ IOSCO Memorandum, *supra* note 1, at 2. SEC Chairman Richard Breeden noted that: "If a capital rule is not market neutral, it will essentially function as an indirect system of credit allocation by the government. By creating an artificial incentive to invest in certain types of securities rather than to make loans, the current Basle standards seem to fail the test of market neutrality." Remarks of Richard C. Breeden, Chairman of the U.S. Securities and Exchange Commission to the Institute of International Bankers, New York, New York, at 11 (May 27, 1992)(also cited in *SEC Chairman Urges Capital Rules That Cover All Types of Securities*, INT'L. SEC. REG. REP., June 16, 1992, at 6).

a level playing field might emerge.¹⁸⁸

V. The European Community's Capital Adequacy Directive

The EC Finance Ministers have examined the amended proposal for the CAD¹⁸⁹ several times during the past two years. The CAD effectively attempts to treat the trading books, defined to include proprietary positions taken in any security,¹⁹⁰ of banks and securities firms in a manner similar to the IOSCO proposal and to treat non-trading book activities of the two types of institutions in the same manner. On the surface, the CAD seems to meet the objective of treating financial conglomerates in a consistent, rational way and avoids distortions between banks and securities firms.

One of the problems with the CAD is that, to the extent that non-trading book activities of securities firms do not constitute banking, it may overstate the need for security firm capital. Thus, the CAD might require bank-like capital charges on securities firms when they act merely as agents for clients or when they are engaging in hedging activities. In contrast, when banks make loans, they do not act as agents for customers and they take the risk that the borrower will not repay them. Thus, one problematic issue was whether arrangements involving the borrowing of stock, such as repos and repurchase agreements, should be treated like securities transactions involving a trading position and be subject to the CAD or if they should be treated like secured bank loans and thus be subject to higher bank requirements. The EC decided that these agreements fall under the CAD.¹⁹¹

The Amended CAD also calls into question the degree to which the IOSCO proposals represent a consensus among securities regulators: the CAD differs in several significant respects from the IOSCO guidelines, even though EC members are also IOSCO members. In June, the EC Finance Ministers agreed that the CAD should be reviewed within three years to take into account changes in inter-

¹⁸⁸ This will not be an easy task. The effects can be seen, for example, on Chemical Bank. Chemical found that its capital/risk-weighted asset ratio, as calculated for bank capital standards, was higher when it included its securities subsidiary than when it excluded this subsidiary. See CHEMICAL BANKING CORP. 1990 ANNUAL REPORT 33 (1991). To the extent that it counts capital from its securities subsidiary, Chemical may be more competitive than other banks because they face a lower cost of engaging in banking activities than other banks.

¹⁸⁹ Directives are a form of EC lawmaking. The Capital Adequacy Directive is not final; it still must be presented to the European Parliament and approved by the twelve member states of the European Community. See *Credit Institutions*, *supra* note 6. The June, 29th accord will be officially published in fall 1992, after a final text is approved. The following discussion is based on the January version of the Amended CAD proposal, an EC press release, and various news reports.

¹⁹⁰ See Amended CAD, *supra* note 6, at 14.

¹⁹¹ See Amended CAD, *supra* note 6, at 15; Simon Landon et al., *Muted Cheers for the Single Market: Attempts to Unify European Securities*, FIN. TIMES, June 11, 1992, at 23.

national markets.¹⁹²

Under the present approach, overall capital requirements would include requirements on initial entry and other risks, trading book, nontrading book, and large exposures.¹⁹³ Under the revised CAD agreed in June 1992, non-bank firms could rely on subordinated debt for total capital for an amount equivalent to 250% of equity capital if illiquid assets are not deducted or up to 250% of equity capital if non-liquid assets are deducted. Banks' subordinated debt may amount to 250% of equity capital.¹⁹⁴ In contrast, the IOSCO Memorandum would allow securities firms to rely on an amount of subordinated debt equivalent to 250% of equity and the Basle standards for banks would count an amount equivalent to 50% of equity.

Initial capital for securities firms would depend on their level of activity. The CAD would not apply to securities firms engaged solely in investment advice and/or processing of investors' orders without holding money or securities on their behalf. Initial capital would be set at ECU 50,000 for firms that act as intermediaries but do not hold clients' money or securities; ECU 125,000 for firms managing investor portfolios or taking orders from investors; and ECU 730,000 for large firms that take market positions or orders from clients.¹⁹⁵ Securities firms would also be required to hold an additional amount of capital equivalent to one quarter of their previous year's fixed overhead.¹⁹⁶ Together, the initial and other risk requirements are equivalent to base and minimum capital requirements.

Capital requirements against position risk would, as under the IOSCO Memorandum, be assessed using the building block approach that separates specific issuer risk and general market risk. According to the January version of the CAD, capital charges for specific risks on debt positions would be: (1) 0% for central government securities; (2) on qualifying items, .25% if due within the next six months, 1.0% if due within six to twenty-four months, and 1.6% if due in more than twenty-four months; and (3) 8.0% on all other items.¹⁹⁷ Capital charges for general market risks would be assessed in a manner more consistent with the Carosio proposals, rather than the stricter SEC proposals, toward which the IOSCO Memorandum asserted that securities regulators were leaning.¹⁹⁸ The Amended

¹⁹² See *Economic and Financial Questions*, 1595th COUNCIL MEETING (Press. Rel. 7460/92, Press 132), June 29, 1992, at 6 [hereinafter *Questions*].

¹⁹³ Amended CAD, *supra* note 6.

¹⁹⁴ See *EC Finance Ministers Reach Agreement on Investment Services, Capital*, INT'L. SEC. REG. REP., July 14, 1992, at 1.

¹⁹⁵ See *Questions*, *supra* note 192, at 5-6.

¹⁹⁶ Amended CAD, *supra* note 6, Annex IV at 49.

¹⁹⁷ *Id.* Annex 1 at 34.

¹⁹⁸ Compare Amended CAD, *supra* note 6, Annex 1 at 35-40 with SEC, *Debt Paper*, *supra* note 135 (discussing Carosio proposal).

CAD also provides for calculating general market risks using a duration methodology.

On equity position risk, the January version of the amended CAD follows the IOSCO by requiring a specific risk charge of 4% against the sum of net long and net short positions and a general market risk charge of 8% against the overall net position.¹⁹⁹ In several areas, however, the Amended CAD appears to provide for an easing of capital requirements relative to the IOSCO proposals. For example, the Amended CAD provides that the specific risk charge could be reduced to 2% if: (1) the equities are not those of issuers that would attract an 8% capital charge on debt securities; (2) the equities are highly liquid; and (3) no individual position within the portfolio amounts to more than 5% of the value of the overall gross position of the portfolio.²⁰⁰

The Amended CAD also spells out in greater detail the treatment of specific instruments and hedging strategies. It also permits the use of financial models to assess the underlying risks of options and swaps, and to serve as a factor in determining capital requirements.²⁰¹ The IOSCO Memorandum suggested that more work needs to be done in these areas. The Amended CAD also clarifies the treatment of underwriting. For example, no capital requirements against securities being underwritten shall be imposed until it is clear exactly how many securities the firm will be required to accept under the underwriting agreement.

Capital requirements would be assessed against foreign exchange risks.²⁰² In contrast to the CAD, IOSCO has not yet determined how to take into account foreign exchange risks and the Basle Accord aims only at taking into account the credit risks associated with foreign exchange contingencies.²⁰³ If a non-bank has a large exposure, defined as an amount equivalent to 25% of its capital, to an individual or a group of connected clients, the firm shall be required to meet additional capital requirements. Initially, the firm will have a ten-day window before capital requirements increase because of the large exposure. The ten-day window reflects in part concerns by primary dealers and underwriters that they would be unable to fully place an issue without facing prohibitive capital costs. In earlier drafts of the CAD, a five-day window had been proposed.²⁰⁴

¹⁹⁹ Compare Amended CAD, *supra* note 6, at Annex 1 at 41 with IOSCO Memorandum, *supra* note 1, at 8 (similar equity position guidelines).

²⁰⁰ Amended CAD, *supra* note 6, Annex I at 41.

²⁰¹ *Id.* Annex I at 31-33.

²⁰² See *id.* Annex III at 47-48.

²⁰³ Compare Amended CAD, *supra* note 6, at Annex III, with Basle Accord, *supra* note 2 and IOSCO Memorandum, *supra* note 1, 1-8 (no mention of foreign exchange risks in the IOSCO consensus).

²⁰⁴ See Questions, *supra* note 192. See Credit Institutions, *supra* note 6. The International Primary Market Association believes that the CAD could substantially raise capital require-

VI. Conclusion

The challenge in the efforts to harmonize regulations among securities firms and between banks and securities firms is to simultaneously ensure that: (1) the safety and soundness of the global financial system is preserved; (2) neither entity gains an unfair advantage through cheaper costs of doing business; and (3) both entities have an adequate degree of capital and prudential regulation in the event of difficulties.²⁰⁵ Efforts to harmonize regulations among securities firms are proceeding under the auspices of IOSCO. Considerable progress appears to have been made in identifying the main issues and the possible basis for developing a framework. Securities regulators, however, are still grappling with the issues that bank regulators overcame when they designed the Basle Accord framework for credit risk for universal banks and banks solely engaged in banking. Securities regulators are seeking to harmonize regulations among a greater variety of institutions and intermediaries, regulatory structures and activities and entities that may have previously gone unregulated.

Securities regulators appear to be willing to live with a framework that attempts, like the Basle Accord, to separate the types of risks against which capital should be assessed. Further, regulators appear to agree on some of the elements for a common framework based on building block approach, although the United States, if it followed the IOSCO consensus, would also maintain its comprehensive approach. Substantial work remains to be done to develop a common definition for (1) capital; (2) haircuts on equities, debt instruments, and derivatives; and (3) treatment of trading strategies and offsetting rules.

One danger that must be minimized is that, in apparently equalizing the capital adequacy rules among securities firms and other securities market participants, regulators do not place too high a burden on some intermediaries that do not engage in the variety of activities of major multinational securities firms. Assessing the same capital requirements placed on dealers against brokers would prove

ments relating to underwriting activities. In comparing the CAD with U.K. rules, the Association notes that U.K. rules allow a twenty-eight-day window for underwriting activities. See *Implications of CAD and LED in the International Primary Market*, FIN. REG. REP. (May 1992).

²⁰⁵ As one observer put it,

The issue is not really one of trying to establish a level playing field, but of trying to arrange for two games to be played under a single referee on the same pitch. In rugby football, players can pick up the ball in their hands and run with it. Whilst that may appear to give them a significant advantage over their soccer playing brethren, they labour under the very severe handicap that the ball cannot be passed forward. However, it would be useless to try to create competitive equality between a rugby and soccer team, since (apart from the shape of the ball) the objectives of each game and the scoring system are quite different.

Developments on the Capital Adequacy Directive, FIN. REG. REP., Nov. 18, 1991.

too costly for brokers. This danger is, perhaps, minimal because large multinational securities firms generally act both as brokers and dealers and the common framework would apply only to such firms.

Similarly, efforts to develop comparable capital adequacy rules for banks and securities firms may run the risk that similar rules are applied to entities with very different activities and risks. These concerns suggest that banking and securities activities might best be governed by different regulators, with some arrangement, as in the United Kingdom, for one regulator to take primary responsibility for supervising a given entity. To the extent, however, that financial conglomerates engaging in a broad array of financial activities are really the key financial institutions of the future, the best arrangement may well be for a single regulator to supervise the entire entity. Appointment of a single regulator would avoid costly overlapping regulation and ensure that the entire entity focused on the risks facing it.

The EC's CAD, which attempted to develop a level playing field for its financial institutions, has developed a framework to apply functional capital adequacy rules so that, for example, banks' securities portfolios are treated in the same way as security firms' proprietary positions. In other areas, however, the CAD may impose similar regulations on financial institutions engaging in very different activities, thereby creating distortions in their financial systems. Moreover, the CAD diverges, in some respects, from the direction in which IOSCO appears to be headed and may make the harmonization of international regulations more difficult.

Current efforts at harmonizing regulations do not focus either upon splitting responsibility between regulators or upon forming a single regulator for the emerging financial conglomerates. Rather, they focus on harmonizing rules first among securities regulators and then between securities regulators and bank supervisors. The current efforts to harmonize rules runs the risk of creating greater instability by applying similar rules to dissimilar activities. However, current efforts may be more politically acceptable than mandating regulatory approaches and may, in the end, wind up at the same point: achieving sensible rules for global financial conglomerates.

